DEPARTMENT OF STATE REVENUE

04-20110235.SLOF

Supplemental Letter of Findings: 04-20110235
Gross Retail Tax
For the Tax Years 2007-2009

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ISSUES

I. Sales and Use Tax–"Maintenance Agreements."

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-17; IC § 6-8.1-3-3; IC § 6-8.1-5-1; 45 IAC 2.2-4-2; Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44 (Ind. Tax Ct. 2000); Sales Tax Information Bulletin 2 (December 2006); Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (November 2000); Letter of Findings 04-20100606 (August 12, 2011); Letter of Findings 04-20100311 (June 29, 2011); Letter of Findings 05-0438 (August 11, 2006).

Taxpayer protests the imposition of use tax on its purchase of "maintenance agreements."

II. Sales and Use Tax–"Kitting Activities."

Authority: IC § 6-2.5-2-1; IC § 6-2.5-5-3; IC § 6-8.1-5-1; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Letter of Findings 04-20000017 (May 13, 2004).

Taxpayer protests the imposition of sales and use tax on its purchases used during its "kitting activities."

STATEMENT OF FACTS

Taxpayer operates two facilities in Indiana. Taxpayer sells cell phone accessories and performs logistic and fulfillment services. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional use tax for the tax years 2007, 2008, and 2009. The Department found that Taxpayer had made a variety of purchases on which sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer disagreed with some of the audit results and protested.

Previously the Department issued a Letter of Findings denying Taxpayer's protest. Taxpayer requested a rehearing, which the Department granted. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax–"Maintenance Agreements."

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer purchased various software "maintenance agreements." During the audit, the Department found instances where Taxpayer had purchased software "maintenance agreements" without paying sales tax at the time of purchase, and assessed used tax on the purchases.

Taxpayer maintains that since the software "maintenance agreements" do not contain a provision which guaranteed that Taxpayer would automatically receive software updates and upgrades, the software "maintenance agreements" are not subject to Indiana sales/use tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

In support of its position that the transactions are not subject to sales/use tax, Taxpayer points to 45 IAC 2.2-4-2(a) which states:

> Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax....

Taxpayer also points to Sales Tax Information Bulletin 2 (May 2002), 25 Ind. Reg. 3595, as "outlin[ing] the position of the Legislature and the Department regarding optional maintenance agreements." This version of Sales Tax Information Bulletin 2 stated as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. (Emphasis Added) See also Sales Tax Information Bulletin 2 (November 2000), 24 Ind. Reg. 1192. ("Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.")

Taxpayer acknowledges that the Department subsequently amended the Information Bulletin revising its position. That revision states:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. Sales Tax Information Bulletin 2 (December 2006) (Emphasis Added).

Taxpayer relies on the May 2002 version of Sales Tax Information Bulletin 2 as supporting its position that its maintenance agreements are exempt from sales tax because the maintenance agreements it purchased purportedly do not contain the right to obtain updates. Taxpayer challenges the position taken in the revised December 2006 Information Bulletin because the Department did not promulgate an accompanying regulation. Taxpayer cites to IC § 6-8.1-3-3 which requires as follows:

> (a) The department shall adopt, under IC 4-22-2, rules governing:
> (1) the administration, collection, and enforcement of the listed taxes;
> (2) **the interpretation of the statutes governing the listed taxes**;
> (3) the procedures relating to the listed taxes; and
> (4) the methods of valuing the items subject to the listed taxes.
> (b) **No change in the department's interpretation of a listed tax may take effect before the date the change is:**
> (1) adopted in a rule under this section; or
> (2) **published in the Indiana Register** under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule; if the change would increase a taxpayer's liability for a listed tax. (**Emphasis Added**).

IC § 6-8.1-3-3 states that if the Department changes its "interpretation of a listed tax," it must either adopt a rule (regulation) under IC § 4-22-2 or give notice of that interpretation in the Indiana Register. Taxpayer correctly points out that the Sales Tax Information Bulletin 2 (December 2006), 20100804 Ind. Reg. 045100497NRA, was not published in the Indiana Register until August 2010.

The previous 2002 version of the Information Bulletin did not require the vendor to collect sales tax on the sale of the extended warranties and maintenance agreements; however the vendor was required to self-assess use tax on any parts supplied pursuant to the terms of the warranty or agreement. The subsequent version of the Information Bulletin (December 2006) essentially reversed that requirement. The vendor was required to collect sales tax on the sale of the warranty but was not required to self-assess use tax on any parts supplied pursuant to the terms of the warranty. Presumably the subsequent version of Information Bulletin (December 2006) was a "change in the department's interpretation of a listed tax" as described in IC § 6-8.1-3-3 and triggered the Department's obligation to either adopt a regulation or publish notice of that "change" in the Indiana Register.

However, the Department must point out that prior to the issuance of the Information Bulletin 2 (December 2006), the Department issued Letter of Findings 05-0438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, in which the Department addressed the question of whether "Software Maintenance Agreements" were subject to sales tax. The Department found that these agreements were subject to sales tax on a "prospective basis" as follows:

> There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin [] 2 concerning Optional Warranties... on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation only if there was a guarantee of the transfer of tangible personal property (updates) pursuant to the agreement.
> Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin [] 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. Wholesalers, Inc. v. Indiana Department of State Revenue, 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, **the**

department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax. A taxpayer could rebut this presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty. In this particular taxpayer's situation, the department will apply this interpretation prospectively. (Published in the Indiana Register and available at http://www.in.gov/legislative/iac/20061101-IR-045060474NRA.xml.html) (**Emphasis added**).

As of the publication of Letter of Findings 05-0438, the Department fulfilled its obligation to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the Letter of Findings, "The taxpayer's protest is sustained as to the maintenance agreements and optional warranties in this assessment. The taxpayer is advised that in the future, there will be a rebuttable presumption that all software maintenance agreements and optional warranties will be subject to the sales and use taxes."

In the case of the software maintenance agreements, the interpretations set out in the Sales Tax Information Bulletins are irrelevant. Instead, the interpretation set out in the August 2006 Letter of Findings governs the issue. The publication of that Letter of Findings met the requirements set out in IC § 6-8.1-3-3. See Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44, 49 n.5 (Ind. Tax Ct. 2000) ("The publication of the Letter of Findings is a prerequisite for the Department before it can change its position as to the interpretation of a tax, where the change would increase the taxpayer's liability.")

However, Taxpayer also points out that the Department issued two additional Letters of Findings, Letter of Findings 04-20100606 (August 12, 2011), 20111026 Ind. Reg. 045110638NRA, and Letter of Findings 04-20100311 (June 29, 2011), 20110928 Ind. Reg. 045110489NRA, which sustained protests related to optional maintenance agreements. Taxpayer states that "[t]he Taxpayer's situation is **identical** to the taxpayers in [the two Letters of Findings]." **(Emphasis** in original).

However, the Department cannot agree with Taxpayer's conclusion that the taxpayers in the two cited Letters of Findings are identical to Taxpayer. In Letter of Findings 04-20100606, the agreements in question were automobile warranties. In Letter of Findings 04-20100311, the agreement was a warranty contract on a laptop computer. These Letters of Findings relied upon the lack of publication of Sales Tax Information Bulletin 2 (December 2006) to conclude that the May 2002 version of Sales Tax Information Bulletin 2 controlled for their respective taxpayers.

A timeline of the history of various warranties, maintenance contracts, and the Department's interpretations governing those agreements is useful. In 2002, the Department published Sales Tax Information Bulletin 2 (May 2002). Under this information bulletin, software maintenance agreements and other tangible personal property warranties were generally presumed not to be subject to tax. This was consistent with pre-2002 Department practice and remained the Department's policy until August 2006.

In August 2006, the Department issued Letter of Findings 05-0438. This Letter of Findings reversed the Department's historical position on software maintenance agreements, but on a going-forward basis. Thus, effective in August 2006, the Department's stance was that software maintenance agreements were presumed to provide tangible personal property and thus taxable unless the taxpayer provided evidence to the contrary. However, for maintenance agreements and warranties for other tangible personal property, these agreements still were presumed not to be subject to tax.

During the intervening months from August 2006 to December 2006, the Department reversed its historical position on all maintenance contracts and warranties and concluded that such contracts were presumed to be subject to tax. To reflect the revised presumptive treatment, the Department issued Sales Tax Information Bulletin 2 (December 2006). Sales Tax Information Bulletin 2 (December 2006) was published on the Department's own internet site but was not published in the Indiana Register. The lack of publication in the Indiana Register was not discovered until the summer of 2010.

The effect of not publishing Sales Tax Information Bulletin 2 (December 2006) was that the Department's position from August 2006 was unchanged until proper publication of Sales Tax Information Bulletin 2 (December 2006) in August 2010. Thus, from December 2006 to August 2010, the Department's stance was unchanged from the August 2006 stance because the Department had not published the revised stance.

Nevertheless, the Department assessed the taxpayers in Letter of Findings 04-20100606 and Letter of Findings 04-20100311 as if Sales Tax Information Bulletin 2 (December 2006) had been properly published. These Letters of Findings reflected the Department's interpretation as of August 2006, in which the Department had not extended the reasoning of Letter of Findings 05-0438 beyond software maintenance agreements. However, the taxability of software maintenance agreements remained a narrow exception to the presumed nontaxability of other tangible personal property maintenance agreements. Taxpayer's case involves software maintenance agreements, not other tangible personal property.

In addition, Taxpayer further maintains that software maintenance agreements were not subject to Indiana sales/use tax until the enactment of IC § 6-2.5-4-17 in July 1, 2010, which provides that " a person is a retail merchant making a retail transaction when the person enters into a computer software maintenance contract to provide future updates or upgrades to computer software."

However, the Department must disagree. As discussed previously, the Department has consistently found

that software maintenance agreements were presumed to be subject to sales and use tax for several years prior to the enactment of this legislation. Therefore, even when Taxpayer's argument–that this legislation changed the law–is presumed correct, a change from the current law would be changing the law from software maintenance agreements being subject to tax with a rebuttable presumption to software maintenance agreements always being subject to tax without the availability of a rebuttable presumption.

Taxpayer raises other contentions regarding the propriety of the Department's ruling in the original Letter of Findings related to this protest. While the Department recognizes Taxpayer's concerns, Taxpayer's contentions do not provide sufficient legal or factual grounds for the Department to determine that the proposed assessment was incorrect.

FINDING

Taxpayer's protest to the imposition of use tax on its purchases of software "maintenance agreements" is respectfully denied.

II. Sales and Use Tax–"Kitting Activities."

DISCUSSION

The Department again notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The Department determined that Taxpayer had made several purchases without either paying sales tax at the time of purchase or remitting use tax to the Department, and assessed use tax on the purchases.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Taxpayer makes the general assertion that certain of its purchases that are used in its "kitting" activities are not subject to use tax because the purchases would qualify for the manufacturing equipment exemption under IC § 6-2.5-5-3. Taxpayer further maintains that in the situations where it does not purchase the cell phones and accessories it uses in the "kitting" activities, Taxpayer qualifies for the manufacturing exemption as an industrial processor as found in 45 IAC 2.2-5-10. In regards to the factual basis of Taxpayer's protest, Taxpayer's protest letter states:

> [Taxpayer's] operations relate to assembly of telecommunication components for delivery to customers; a process commonly referred to as "kitting." "Kitting involves the transformation of an unusable product (i.e. a non-functioning cell/smart phone) into a usable product (i.e., a fully-functioning cell/smart phone). "Kitting" includes, but is not limited to, programming and installation of a SIM card, installation of a battery, assembling the applicable instruction manual, phone charger, related software and any other accessories or materials into a final package for delivery to the customer. As such, Taxpayer routinely purchases various pieces of equipment and warehouse supplies that are utilized or consumed throughout the course of the production process.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

Notwithstanding that Taxpayer failed to present sufficient documentation explaining the items at issue and how specifically Taxpayer uses those items, Taxpayer's purchases would not qualify for the manufacturing exemptions found at IC § 6-2.5-5-3. Taxpayer is a not a manufacturer of goods for sale. The Department notes that it has addressed this issue of Taxpayer's "kitting" activities for Taxpayer's parent corporation and issued Letter of Findings 04-20000017 (May 13, 2004), 27 Ind. Reg. 3779, in which the Department denied the Taxpayer's protest finding that Taxpayer's "kitting" activities did not qualify as manufacturing.

As to the substance of Taxpayer's protest, the Department's regulations emphasize that the tangible personal property that are the "raw materials" of a manufacturing/processing/refining process must be substantially changed in their "form, composition, or character" such that the resulting tangible personal property is a different product having a distinctive "name, character, and use." The resulting product must be substantially different from the component materials used.

45 IAC 2.2-5-8(k) states:

> "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in **a form, composition, or character different from that in which it was acquired.** The change in form, composition, or character must be **a substantial change,** and it must result in a transformation of property **into a different product** having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

(**Emphasis added**).

45 IAC 2.2-5-10(k) states:

Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. **A processed or refined end product, however, must be substantially different from the component materials used.**

(**Emphasis added**).

Based upon the documentation submitted, Taxpayer does not perform operations on the property that cause a "substantial change" in "form, composition, or character" to the component materials it used. While the Department recognizes that the cell phones undergo some changes–particularly the addition of software to cell phones and the assembly of cell phones from component parts–Taxpayer's process itself does not result in an end product "substantially different" from the original component products necessary to permit tax exemption. Thus, Taxpayer's "kitting" activities constitute the performance of a service that does not constitute the "substantial change" in "form, composition, or character" as contemplated by statute or regulation. Therefore, Taxpayer's protest to the imposition of use tax on its purchases involved in its "kitting" activities is denied.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer's protest, as discussed in Issue I and II, is respectfully denied.

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